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DIRECTORATE OF
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Intelligence Memorandum

New Shifts in Economic Policy in Yugoslavia

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
August 1968

INTELLIGENCE MEMORANDUM

New Shifts in Economic Policy in Yugoslavia

Summary

Yugoslavia is now shifting away from the economic policies of 1965-67, which eased inflationary pressures and led to a reduction of controls over prices and imports. These policies also resulted in a dramatic slowdown in economic growth and did little to stimulate efficiency. Stagnating industrial production and rising unemployment -- and the mounting public criticism that has resulted -- have forced Tito to retreat part way toward the pre-1965 policy of rapid growth under tight controls.

Inflationary pressures and chronic balance-of-payments problems led in 1964 to a major critique of economic policy. The leadership concluded that rapid growth, fueled by easy credit in a protected market, would increasingly require government intervention to correct maladjustments. Moreover, the continued development of noncompetitive lines of production would tend to make Yugoslavia increasingly dependent on Communist countries for export markets. The policy of forced economic growth thus would lead away from the goals of a free domestic market and an independent position in the world, between West and East.

A new strategy therefore was adopted in which growth was to be subordinated to structural change and increased reliance on market forces. In 1965-66 the government put the brakes on consumer and investment spending, revised the price structure, devalued

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the currency, and reformed the banking system, in preparation for a major cutback in direct government controls. In 1967, import controls were relaxed or entirely removed for a wide range of goods, exposing producers to increased foreign competition. During the year, price controls on many of the goods that Yugoslavia imports were removed.

Unfortunately, these policies did not work out as planned. They did not accomplish nearly so much as the government had expected in improving the output mix or in increasing the competitiveness of Yugoslav industrial goods in world markets. Moreover, the little progress that was made was bought at the price of an unforeseen collapse of growth in industrial output. Investment fell by almost 30 percent during 1965-67 -- far more than had been expected -- with a resulting 30-percent drop in construction and a slow-down in the output of building materials, steel, and machinery. The relaxation of restrictions on imports of industrial materials, machinery, and some consumer goods led to a substitution of foreign for domestic products and a shift away from imports from Communist countries to imports from Western countries. The overall result was a sharp rise in inventories during 1965-67 and a rapid decline of the rate of industrial growth from 16 percent in 1964 to an actual drop in output in 1967. Employment in industry fell by 3 percent during 1965-67. Moreover, the import liberalization contributed to an unexpected worsening of the hard currency deficit from $299 million in 1966 to $436 million in 1967.

Eventually, in late 1967, the government gave in to demands for help from the areas and industries most directly affected by current policies. The leadership has recontrolled many imports, has raised tariffs in order to assure markets to depressed industries, and has increased the volume of credits for exports, investments, and consumer purchases. Results for the first six months of 1968 indicate that the government's policies have begun to take effect. Industrial production is up 4 percent over the first half of 1967, investment in money terms is up 16 percent, and the rise in inventories has begun to slacken. Import controls have held the hard currency deficit below last year's level for the same period,

even though agricultural exports have dropped. The regime now expects a revival of the rate of growth of industrial output to 5 or 6 percent this year and hopes that this can be accomplished without a further retreat from the price and import liberalization carried out in 1967.

The Yugoslavs probably will not be able to reduce further the need for government intervention in the economy. As in other developing countries, the commitment to rapid growth will produce strong inflationary pressures. The need for imports to support growth will often outrun the ability to export, causing periodic balance-of-payments difficulties. Because entrepreneurial skills and incentives are lacking, it will be largely up to the government to push investment into profitable channels and to stimulate innovation. The present leadership will continue trying to reconcile economic growth with increased reliance on market forces. It will go on using *ad hoc* indirect controls to deal with pressing economic problems rather than revert to systematic direct controls. Tito's successors, however, lacking his personal prestige and needing to establish a national power base, will find it much harder to resist demands for growth at any price and may well abandon the hope of achieving "market socialism."

The Nature of the Economy

1. The Yugoslav economy is semideveloped, with levels of productivity and per capita income that are among the lowest in Europe. There are striking differences in economic development among regions; the per capita gross national product of Slovenia, the richest area, is five times that of Kosovo i Metohija, the most backward. Past rates of growth in industry have been among the highest in the world, but rapid growth usually has been accompanied by inflationary pressures and balance-of-payments difficulties. Agriculture, which employs about half of the working population, has had an erratic growth pattern, largely because of varying weather conditions.

2. Yugoslavia's economic system is intended to combine state ownership of the means of production, workers' management of enterprises, and relatively free operation of market forces with a minimum of direct government interference. The leadership laid the basis for such a system during 1950-55. The government stopped imposing obligatory production goals, abolished the economic ministries, gave up the state monopoly of foreign trade, discontinued the compulsory collectivization of agriculture, and introduced workers' management councils in enterprises. In practice, however, the government continued to manipulate economic activity by directly regulating prices, incomes, and imports, as well as by indirect credit controls.

3. Subject to these regulations, the workers' councils have gradually acquired influence in enterprise management and the economy has taken on some of the characteristics of a market economy. Enterprises can decide what and how much to produce. Subject to tax and minimum wage legislation, they can decide how to distribute enterprise income. The economy, however, still has only a rudimentary capital market, and direct government control over prices and imports frequently has interfered with the operation of market forces.

Growth vs. Efficiency

4. The basic Yugoslav economic goal has long been rapid growth. In the 1950's, propelled by a

large increase in the money supply and government investment and protected by subsidies and import controls, industrial output nearly tripled. The range of industrial products was broadened substantially, the share of industrial products in total exports was increased from 53 percent in 1952 to 65 percent in 1960, and real per capita national income nearly doubled. Of course, this growth was in part illusory; much of the new capacity created could be operated only under a continued policy of easy credit and broad import restrictions.

5. The rapid expansion of investment credits and of consumer incomes created strong inflationary pressures. The government relied on a substantial degree of direct price control in the nonagricultural sector to suppress inflation. Prices in agriculture, however, generally were allowed to rise in an effort to stimulate production. Increases in food prices largely accounted for the average annual increase of 5 percent in the cost of living during 1953-60. Quantitative controls were imposed on most imports, but the heavy dependence of industrial growth on imports of raw and semifinished materials and capital equipment still created large cumulative deficits in the balance of payments. These deficits were financed by foreign credit, largely from the West.

6. By the early 1960's, inflationary pressures and balance-of-payments problems forced the government to adopt a deflationary policy. Beginning in 1961, restrictions were placed on investment and consumer credit, on the use of enterprise funds, and on wages. In addition, the dinar was devalued; a single exchange ratio was adopted in place of multiple exchange rates (although export subsidies were retained); and a tariff system was instituted. Under the impact of these measures the rate of growth of industrial output was cut from 14 percent in 1960 to about 7 percent in 1961 and 1962.

7. The slowdown in growth and a recovery in the foreign payments balance in 1962 prompted the government to ease restrictions somewhat in the second half of 1962. Then in 1963, with revival well on its way, the government began pushing the economy again. An expansionary credit policy and a more lenient tax policy led to a rapid upsurge in demand, which in 1964 resulted in renewed inflationary pressures and a

severe balance-of-payments crisis. Dwindling opportunities to obtain new foreign credits and large repayment burdens from past credits forced the regime to retrench once again. A new deflationary program was launched beginning in mid-1964, followed by a far-reaching economic reform adopted in July 1965.

8. First of all, the new program involved expedient measures to halt inflation and redress the balance of payments. The growth of the money supply was cut sharply by a tight credit policy that restrained investment and consumer spending. The government also held back its own investment program and froze 20 percent of enterprise investment funds. A general freeze on industrial prices was levied in March 1965. This was followed by a price reform combined with devaluation of the dinar in July 1965, which brought Yugoslav prices closer to those in world markets.

9. The price reform was primarily responsible for the 33-percent increase in the cost of living in 1965; about 90 percent of industrial prices were recontrolled after the increases prescribed by the reform had been effected. The restraints on domestic demand and prices, reinforced by direct controls on nearly all imports and aided by increasing earnings from tourism, resulted in small surpluses in the balance of payments on current account in 1965 and 1966 -- the first since the break with the Cominform in 1948. Moreover, foreign creditors were asked, and many consented, to defer Yugoslav debt repayments, and Yugoslavia was able to obtain new credits, including a standby credit from the International Monetary Fund (IMF), in support of its reform program.

10. The program also included measures intended to correct some of the basic imbalances and inefficiencies in the economy. The price reform raised agricultural and raw materials prices relative to prices in manufacturing in order to stimulate the growth of agricultural output and force increases in efficiency in manufacturing. Enterprises were exposed somewhat more fully to international competition by a reduction in customs tariffs and by the

abolition of most export subsidies in 1965. At the beginning of 1967 the government removed direct controls on most imports of fuels, raw materials, and semifinished industrial products, and relaxed quotas on imports of machinery and some consumer goods. Steps were also taken to shift the financing of investment from political bodies to banks and enterprises and to lift most restrictions on the authority of enterprises and banks to engage directly in foreign trade. Finally, a law adopted in mid-1967 permitted foreign investment on a partnership basis with Yugoslav firms in the hope of attracting Western capital and know-how and establishing new export outlets.

11. By 1967 the deflationary program had largely succeeded in enforcing greater price stability. As shown in the accompanying table, industrial wholesale prices increased by only 2 percent in 1967 compared with 11 percent in 1966. The cost of living rose by 6 percent in 1967 compared with 24 percent in 1966; most of the increase in 1967 resulted from hikes in rent and in the prices of other services which were enacted at the beginning of the year. Banner years in agricultural production in 1966 and 1967 were reflected in a 3-percent decline in agricultural producers' prices in 1967. About half of the industrial prices at both the wholesale and the retail levels had been freed from control by the middle of 1967.

12. The regime's program was expected to lead to a temporary drop in the rate of increase of industrial output. The government, however, did not anticipate the extent to which enterprises and consumers would be affected by the deflationary program and by increased foreign competition. Investment declined by almost 30 percent in real terms during 1965-67 -- far more than the government had expected. Construction fell by 30 percent during the same period, leading to marked slowdowns in the output of building materials, steel, and industrial machinery. Although personal incomes continued to increase, except for a brief period following the price reform in 1965, controls on consumer spending led to a slowdown in the production of clothing, leather goods, footwear, furniture, and other consumer manufactures. Moreover, the liberalization of imports in 1967 encouraged enterprises and consumers to substitute foreign for

Yugoslavia: Impact of Economic Policy
1964-68

	Percentage Change from Previous Year				Percentage Change from Jan-Jun 1967 to Jan-Jun 1968
	1964	1965	1966	1967	
Production and employment					
Gross national product	11	2	8	2	N.A.
Industrial output	16	8	4	-Negl.	4
Income distribution					
Real gross fixed investment	15	-14	-2	-13	16
Average real personal income	12	2	11	7	2 a/
Prices					
Industrial wholesale prices	5	14	11	2	0
Agricultural wholesale prices	24	43	16	-3	-3 a/
Cost of living	12	33	24	6	4
Trade					
Total imports	25	-3	22	8	0
Total exports	13	22	12	3	-6
Hard currency imports	23	-4	13	21	0
Hard currency exports	7	9	23	9	3

a. *January-April.*

domestic products, which further aggravated the slowdowns in the steel, machine building, and consumer goods industries and added chemicals and wood products to the list of depressed industries.*

13. The end result of these developments was an unintended stagnation of industrial output and a sharp rise in unemployment. Producers' inventories piled up at an accelerated rate, increasing by a total of 82 percent during 1965-67. The rate of industrial growth plunged from an increase of 16 percent in 1964 to an actual decline in output in 1967. Industrial employment dropped during the same period by 3 percent and the total number of registered unemployed** climbed from 228,000 at the end of 1964 to 318,000 at the end of January 1968. In addition, the liberalization of imports led to an unforeseen upsurge in hard currency imports in 1967, which, together with lagging hard currency exports, wiped out earlier gains made in 1965 and 1966 in the hard currency trade balance. At the same time, imports from Communist countries declined, resulting in an unwelcome trade surplus on clearing account.

14. Some industries, such as petroleum, nonferrous metals, electrical goods, shipbuilding, rubber, and paper, were able to weather the recession fairly well and maintained annual rates of growth between 3 and 13 percent. The coal industry suffered the greatest drop in output -- a 14-percent decline during 1965-67. This decline reflects an accelerated substitution of oil for coal in industry and households as a result of the price reform; coal prices increased by 54 percent during 1965-66 while petroleum prices dropped by 5 percent during this period. Oil production expanded by 30 percent during 1965-67.

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*** This measure understates the actual number of unemployed; a survey published in April 1968 gave an estimate of 422,000 unemployed, or about 4 percent of the labor force. Under US or other Western practice the figure would doubtless be higher.*

15. The deflationary program and price reform drove some unprofitable firms out of business and prompted others to merge and to specialize in order to cut costs. In general, however, the reform and deflationary measures did not produce the desired increases in industrial efficiency. By 1967, in fact, the deflation probably had begun to impair productive efficiency. Investment in modernization in 1967 represented less than one-quarter of total investment compared with the planned objective of 53 percent for the period 1966-70. Labor productivity grew only 1.4 percent in 1967 compared with an average annual increase of about 5 percent during the preceding four years.

16. The industrial stagnation triggered an unprecedented barrage of public criticism, mainly centered in Croatia and Slovenia. Economists and businessmen objected in particular that the government's new liberalized trade system had done little to strengthen incentives to export. They also accused the government of issuing misleading reports on the state of the economy in defense of its policies. These criticisms were accompanied by a mixture of demands from industry -- for increased protection, lower taxes, easier credit, and permission to retain foreign exchange earnings.

17. Spurred by these criticisms, the government in late 1967 made an about-face in economic policy with the objective of reviving growth in 1968. The goals were to increase industrial production and the national income by 3 or 4 percent in 1968 and total employment by one percent. Gross investment was expected to increase by 8 percent, or about double the increase forecast for the national income. To accomplish these objectives, the government loosened credit terms for exports and domestic sales of equipment and consumer goods. Tito's advisers hope that the planned expansion of housing construction and automobile production will provide outlets for the use of personal savings deposits.

18. At the same time, the government has taken steps to hold the line against inflation and balance-of-payments deficits. Personal incomes have been frozen until the end of 1968 in service sectors such

as banking, trade, and insurance, where the most rapid increases in wages have been occurring. Average money incomes for the entire economy are expected to increase by only 6 percent in 1968, compared with an increase of 15 percent last year. Moreover, the government has recontrolled over 10 percent of the previously liberalized imports -- particularly products of industries, such as iron and steel and chemicals, that were hardest hit by increased foreign competition.

19. In addition, the government in July 1968 stopped the import of consumer goods from hard currency countries until September 1968, owing to a shortage of foreign exchange. The government hopes that the rise in imports of goods and services can be held to 7 to 8 percent and that exports can be boosted by 7 to 10 percent in 1968. The regime also predicts a reduction in the hard currency deficit and hopes to whittle down the Yugoslav surplus on clearing account which has been accumulated in Eastern Europe.

20. Judging from data for the first half of 1968, these policies have taken effect. After a stagnant first quarter, industrial production began to rise and registered a 4-percent increase in the first half of 1968 compared with the same period in 1967. The only branches that have not increased their output over the first half of 1967 are the machinery and equipment, textile, leather and footware, rubber, and food industries. Investments also have turned up, increasing by 16 percent for the first half of 1968 over 1967, chiefly in manufacturing and mining. Employment, down by one percent compared with the first half of 1967, still has not responded to the revival.

21. Imports have been held at the same level as last year, while exports dropped by 6 percent during the first half of 1968, so that the overall trade deficit has continued to increase. Higher tariffs in EEC countries and the British devaluation of the pound have caused a decline in Yugoslav sales of meat and other agricultural goods to hard currency markets. On the other hand, exports of industrial raw materials and manufactures to hard currency countries have recovered from last year's poor showing, partly offsetting the decline in agricultural exports. Hard currency imports have been held at

about last year's level. Thus the hard currency trade deficit has improved slightly from the level of about $275 million in the first half of 1967.

22. The revival clearly shows the effect of the greater import protection given, for example, to the iron and steel and chemical industries. These industries, together with shipbuilding, construction materials, and electrical products have led the advance thus far. Demands for increased protection now are being heard from other industries, notably the metal products (largely machinery and equipment) industry, whose production has continued to drop since 1965. Hurt first by the drop in investments, this industry since 1967 has been suffering from increasing imports of better quality equipment under favorable credit terms. Spokesmen for this industry complain that they cannot grant the same credit terms as foreign producers. Primarily, however, they seem to be angling for increased administrative control of machinery imports, which would be another step backward from the avowed aims of economic policy.

Prospects

23. The revival in industry should continue through most of 1968. The present official forecast is that industrial output will grow by 5 to 6 percent, or about 2 percentage points above the original estimate. The rise in inventories of finished goods has slackened, and enterprises in some sectors appear to have begun to work down excess stocks. The temporary ban on hard currency imports of consumer goods and the recent tightening of import controls on some textiles may give a lift to the output of light consumer goods which continued to stagnate during the first half of 1968. Overall economic growth, however, may be threatened by the probable drop in agricultural output as a result of the recent drought. The poor crop forecast and the problems encountered in exporting agricultural products have dimmed prospects for any significant improvement over last year's estimated deficit in the balance of payments of $80 million on current account. In addition, receipts from tourism are now expected to increase only slightly over the 1967 level.

24. The present regime believes that the best course for Yugoslav development is to build up lines of production that are competitive in world markets, particularly hard currency markets. In the past, Yugoslavia was able to rely on expanding exports of agricultural products and industrial raw materials to hard currency countries and on substantial Western credits in order to obtain the imports needed for industrialization. Now the Yugoslavs find it difficult to maintain a growing hard currency market for agricultural products. Also, credits no longer present a significant net addition to resources, because of repayment commitments on existing indebtedness. Thus if Yugoslavia wants to continue to buy high-quality Western equipment and other products and also keep a balance in its trade between West and East, it must be able to rely on increased exports of manufactures to hard currency countries.

25. The regime believes that the best way to increase the competitiveness of Yugoslav manufactures is through greater exposure to foreign competition and a freer operation of market forces at home. The regime, however, periodically will have to retreat from these policies because the Yugoslav economy and its institutions still are highly vulnerable to maladjustments in prices, in foreign trade, and in the pattern of resource distribution, particularly when the economy is left more or less to its own devices. The government cannot rely on domestic competition to police prices and stimulate efficiency because the small size of most Yugoslav markets breeds monopolies.

26. Freer foreign competition cannot be consistently used as a substitute for domestic competition because of Yugoslavia's chronic adverse trade balance. Foreign competition, in any event, might not be an effective antidote for inflation; some relatively open Western economies have run into inflationary problems. Moreover, the government cannot give a blank check to enterprise management to set prices and distribute enterprise income. Management under the influence of Yugoslav workers' councils tends to be inflationary. The concern of workers for maximizing present earnings puts pressure on prices and stifles any incentive for managers to undertake forward-looking projects. Finally, the banking system still is influenced

by local and regional vested interests which hamper the flow of capital to the more efficient and profitable areas of the economy.

27. These problems will continue to force the government to intervene periodically with controls on prices, imports, investments, and incomes. As in recent years, the government probably will use price controls and a selective policy to prod enterprises to improve efficiency. When the hard currency deficit becomes unmanageable, however, the quest for efficiency will be sacrificed by increasing protection and by increasing trade with Communist and less developed countries under barter arrangements.

28. As long as Tito remains in power, the government will stress efficiency. Yugoslavia should be able to slowly and sporadically uncover new lines of exports and modernize the more competitive areas of the economy such as food processing, wood products, and nonferrous metals. Foreign investment could help, but it probably will be a long time before substantial foreign investment can be attracted. The only major deal involving a Western country that has been concluded thus far under the new law is an agreement between Fiat of Italy and Zastava, the Yugoslav automobile factory initially set up by Fiat. It is doubtful that the regime will be either willing or able to remove instead of suppressing the unstable features built into the system. Unfortunately, under the present setup, a further decentralization of economic authority to the enterprises and banks may require the government to intervene more frequently in the economy. The constant changes that now are made in government regulations already must have a demoralizing effect on enterprises.

29. After Tito leaves the scene, however, the progress in liberalization that has been made thus far could go down the drain. Tito has personally carried the latest reform into effect and has purged many of the conservative opponents of the program. Nevertheless, the tendency to oppose government economic policies is increasing. For example, the governments of Slovenia and Croatia in 1967 questioned the right of the federal government to impose a 26-percent limit on payroll taxes. Croatian economists

and businessmen have continued to attack the government's analysis of trends in the economy. The student uprisings in June 1968 denounced the drop in employment opportunities brought on by the government's deflationary program and elicited an admission by Tito that all was not well with the reform.

30. Tito's successor, lacking his personal influence, probably will have more of a problem with conflicting demands from regional and industrial interests on questions of resource allocation and the incidence of reforms. Without strong central leadership, regional political and economic influences and conservative opposition could be strengthened enough to thwart the economy-wide thrust of the reform movement and derail the current policy of price stabilization and moderate growth. There is little danger that the system would revert to a Soviet-type command economy. Weak or conservative leadership, however, could bring about a return to a highly protectionist policy and an emphasis on growth for growth's sake.